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In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	))))))	MM Docket No. 92-266

COMMENTS OF CONSUMER FEDERATION OF AMERICA

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PART 1: BACKGROUND

I. OVERVIEW

The Consumer Federation of America (CFA)[1] hereby submits these comments in response to the above-referenced Notice of Proposed Rulemaking on cable rate regulation ("Notice"). CFA and its members played an active role in promoting passage of "the Cable Television Consumer Protection and Competition Act of 1992" ("the 1992 Cable Act") and have a direct interest in the rules implementing the 1992 Cable Act which affect subscription rates, leasing and monthly prices for all aspects of cable television service.

The Notice indicates that the Commission is, at best, confused by, or at worst, hostile to Congress' regulatory directives in the 1992 Cable Act. The Notice misses the mark in describing the Act's rate regulation provisions and relevant legislative history and thereby raises numerous questions and issues that are inconsistent with or irrelevant to the Commission's regulatory task. Since the 1992 Cable Act is in part a clear rejection of the Commission's

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[1] CFA is a federation of 240 pro-consumer organizations with some 50 million individual members. Since 1968, it has sought to represent the consumer interest before federal and state policymaking and regulatory bodies.

past regulatory actions,[2] it is essential that the Commission be extremely careful not to substitute its own judgement for that of Congress in implementing the Act.

In Section II. of these comments, CFA will describe how the Act reflects Congress' clear intent to reduce rates for basic cable and cable programming services to competitive market levels, in order to protect consumers from cable operators that exercise undue market power. This Congressional mandate is harmonized with Congress' goal of promoting the economically justified expansion of cable channel capacity and programming.

Section III. of CFA's comments reviews the economic dynamics of the cable industry. At the same time that Congress expressed its deep concern about monopolistic abuses in the industry, it also recognized the public interest in having a technologically dynamic and economically healthy cable industry. Therefore, as regulation is imposed on the industry, it is important to understand the mechanisms for its progress so that regulation does not <u>unnecessarily</u> retard the industry. Section III. also reviews the qualitative evidence on the nature of the market power problem in the industry. This involves a review of the market structural characteristics of the cable industry which lead to and sustain the

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[2] See Report of the Committee on Energy and Commerce to Accompany H.R. 4850 ("House Report"), 102nd Congress, 2nd Session, Report 102-628 at 33-34, and Report of the Senate Committee on Commerce Science, and Transportation on S. 12 ("Senate Report"), 102nd Congress, 1st Session, Report 102-92 at 8-12.

abuse of market power, the problem that Congress sought to address in the Act. The detail is necessary because of the apparent hesitancy of the FCC to accept Congress' view of the problem.

Section IV. of CFA's comments reviews the evidence which demonstrates that today's cable rates are vastly inflated above the competitive market levels that the 1992 Cable Act seeks to achieve. Congress clearly described the nature and magnitude of rate increases, anti-competitive behavior, and anti-consumer practices of the cable industry which led to passage of the Act. This Section presents quantitative information on the magnitude of the problem. This information, supported by market data, leads to CFA's conclusion that the Commission must devise a regulatory formula which brings basic and cable programming service rates down to competitive market levels.

While Congress left cable operators great latitude in the formatting and positioning of programming, as described in Section V., it established explicit criteria for limiting prices to a reasonable (or not unreasonable) level for basic and cable programming services not subject to effective competition. With the most popular cable programming generally available in a "basic" tier, Congress mandated cost-based price limitations designed to eliminate monopoly rents.

However, aware that some cable operators have (and others could) move popular cable programming to another tier, Congress created a complaint process that enables individuals to trigger rate reductions for other-than-basic-tiers ("cable programming service") where the Commission finds that such rates are unreasonable. In addition, Congress gave the Commission residual authority to prevent "evasions", specifically noting that cable operators who exercise their latitude under the Act to retier programming should not be allowed to harm consumers by raising prices when they shift programming from a basic tier to another tier.

Based on our understanding of Congress' intent, the cable industry's record of massive marketplace abuse in the unregulated environment, and the nature of technological and economic mechanisms within the industry, CFA has crafted an effective set of regulations to implement the 1992 Act's rate provisions. These are presented in Section VI. of our comments.

CFA's regulatory proposal is responsive to many of the specific issues on which the Commission sought comment. However, Section VII. of our comments goes through a number of the more important questions raised by the Commission and responds to them directly, consistent with our analysis of the law and legislative history contained in Sections II. and V., as well as the economic analysis of the industry contained in Sections III. and IV.

II. THE GOALS OF THE ACT

A. LEGISLATIVE INTENT:
COMBINING THE HOUSE AND SENATE RATE PROVISIONS

To understand the goals and purposes of the rate regulation provisions of the 1992 Cable Act, it is essential to review the precise revisions and explanations for changes made by the Committee of Conference ("Conference Report")[3] in combining S. 12, the "Cable Television Consumer Protection Act of 1992" ("Senate bill) with H.R. 4850, the" Cable Television Consumer Protection and Competition Act of 1992" ("House bill"). The Conference Report reflects a compromise that adopts most of the House bill's procedures and mechanisms for regulation, combined with some of the Senate bill's tougher regulatory principles, to achieve a unified regulatory system.

After combining most of the "findings"[4] in the House and Senate bills, the Conference Report adopts the Senate bill's "statement of policy"[5] and then creates a new rate regulation provision by modifying key features of both bills.[6] Working

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[3] Conference Report to Accompany S. 12, "Cable Television Consumer Protection and Competition Act of 1992," 102nd Congress, 2nd Session, Report 102-862.

[4] Conference Report at 55

[5] Conference Report at 58

[6] Conference Report at 62-66

from the House bill's language and format, the Conference Report adopts the Senate bill's basic rate regulation standard ("... the Commission shall, by regulation, ensure that the rates for the basic service tier are reasonable,")[7] and then creates a clear standard by which to measure what is reasonable: regulated basic rates shall not exceed competitive market prices ("... the goal of such regulations is to protect subscribers of any cable system that is not subject to effective competition from rates that exceed the rates that would be charged if such cable system were subject to effective competition.")[8]

While granting the Commission flexibility to choose "the best method" of ensuring reasonable rates, the Conference Report tightens the House language describing factors the Commission "shall take into account" in prescribing regulations. See § 623(b)(2)(C).[9] In general, the Conference Report's modifications to the House "factors" involve precise limitations or the various types of costs that may be allocated to the

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[7] Conference Report at 62

[8] It is important to note that, since this regulatory standard did not emanate from the House bill, the House Committee Report's description of which cable operators should be regulated and which regulatory tools should be used, does not describe either the Conference Committee's views or overall legislative intent of the Congress. See House Committee Report at 79-84. We also note that the Senate did not agree with the House's characterization of the degree or type of regulation the Commission must apply. See Senate Committee Report at 8-12, 18-19.

[9] See also Conference Report at 62.

regulated basic tier to ensure that "... the rates for basic cable service [are] as low as possible," and "...[t]he regulated basic tier must not be permitted to serve as the base that allows for marginal pricing of unregulated services."[10] Therefore, the Commission's basic rate regulation scheme shall "... ensure that joint and common costs are recovered in the rates of all cable services, not only in the rates for basic cable service," and "... the direct costs of providing non-basic cable services are not considered joint and common costs and are not recovered in the rates charged for basic cable service."[11]

The Conference Report includes a number of other modifications to the House language specifically designed to "... keep the rates for basic cable service low."[12] By limiting the portion of franchise fees, taxes and other charges imposed by state and local authorities on cable operators that may be recovered through basic cable rates, and accounting for advertising revenue and any other consideration obtained by a cable operator in connection with the basic service tier, the Conference Report again limits a cable operator's ability to load costs on basic cable subscribers, or prevents cable operators

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[10] Conference Report at 63. Note that the reference to "marginal pricing" was taken verbatim from the House Committee Report, indicating that the Conference Committee did not view the Committee Report as definitive legislative history on the rate regulation section of the Act. See House Committee Report at 83.

[11] Conference Report at 63.

[12] Conference Report at 63.

from concealing revenues that should be applied to reduce basic cable rates.[13]

The Conference Report modifies the House bill's "reasonable profit" provision to "...protect the interests of consumers of basic cable service" by allowing Commission consideration of profitability of all non-basic cable services in establishing a reasonable profit for basic cable service.[14] This modification allows the Commission "... to protect the interests of the consumers of basic cable service" by reducing the allowable profit on basic cable rates based on the profitability of other cable services.

After describing the portion of costs and profits that the Commission shall consider in establishing reasonable basic cable rates, and separating the direct costs, joint and common costs and profits that the Commission shall assign to non-regulated (per-channel or pay-per-view) services, the Conference Report modifies the House bill's complaint procedure for the Commission to determine whether rates for the remaining cable services (i.e., "cable programming service") are unreasonable. It is important to note that cable operators may continue to offer "cable programming service" in the basic tier, as they traditionally have done, and thereby avoid the possibility of

[13] Conference Report at 63.

[14] Conference Report at 63.

complaints being filed against them (i.e., the Commission would automatically establish a "reasonable" price for "cable programming service" included in the basic tier).

The Conference Report expands standing to file a rate complaint to include cable subscribers, and reduces the content of the filing to a "... minimum showing," rather than the House and Senate bills requirement that a complaint demonstrate a "prima facie case."[15] Significantly, the Conference Report rejects the Senate bill's requirement that complaints may only be filed after a rate increase.[16] Instead, the Conference Report adopts the House bill's provision allowing 180 days after basic rate regulation takes effect to file complaints against existing rates for cable programming service. See § 623(c)(3).

Rather than dictate to cable operators how to package non-broadcast programming, or require automatic federal regulation of all cable programming, the Conference Report modifies the House bill's "evasions" provisions "... to protect consumers from being harmed."[17] Despite finding previous Commission regulation inadequate because cable operators retiered their services to

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[15] Conference Report at 64.

[16] Senate Committee Report at 74-75.

[17] Conference Report at 65.

avoid regulation,[18] and after expressing concern about the rate increases such retiering may entail,[19] the Conference Report neither bans all retiering nor automatically regulates all forms of cable service. Instead, the Conference Report gives the Commission broad residual authority to "prevent evasions," and also requires the Commission to devise regulations "... to prevent evasions, including evasions that result from retiering,..." See § 623(h).

By isolating "retiering" as a matter requiring particular Commission regulatory procedures, the Conference Report expresses clear Congressional intent: "The conferees are concerned that such retiering may result in the evasion of the Commission's regulations to enforce the bill. The conferees expect the Commission to adopt procedures to protect consumers from being harmed by any such evasions." [emphasis added][20] Without dictating how to format and package non-broadcast programming, the Conference Report requires the Commission to prescribe regulations that prevent cable operators from charging unreasonable rates for any cable services.[21] However, the

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[18] Senate Committee Report at 8-12, 19-20.

[19] Conference Report at 65.

[20] Conference Report at 65.

[21] The Conference Report reflects both House and Senate presumptions that cable services offered on a per-channel or pay-per-view basis are subject to some competitive market forces and thus need not be regulated. See House Committee Report at 90;

Conference Report allows cable operators to avoid "complaint" and "evasions" regulatory proceedings by continuing to offer a large basic tier priced at a competitive market (i.e., reasonable) rate.

A clear set of regulatory principles that should guide the Commission is evident when the Conference Report's combination of House and Senate rate provisions is viewed in the broader context of the 1992 Cable Act. Congress called for a system of rate regulation designed to approximate competitive market prices until other measures designed to promote competition yield a fully competitive market.

The remainder of this section outlines the goals of the rate regulatory approach embodied in the Act. As Table II-1 shows, Congress took a very broad view of regulation of the industry and set down a comprehensive scheme of regulation when it combined the House and Senate bills to create the 1992 Cable Act.

B. THE OBJECTIVES OF REGULATION

1. PROTECTION OF SUBSCRIBERS

The primary goals of the 1992 Cable Act are crystal clear. After finding considerable monopolistic abuse in the cable

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Senate Committee Report at 20.

TABLE II-1:

OVERVIEW OF RATE REGULATION IN THE CABLE TELEVISION CONSUMER PROTECTION AND COMPETITION ACT OF 1992

OVERALL GOALS OF RATE REGULATION

COMPETITIVE MARKET OUTCOME,
PROTECTION FROM UNDUE MARKET POWER AND EXCESS RATES,
EXPANSION WHERE ECONOMICALLY JUSTIFIED

CONSTRAINTS ON RATES THAT CUT ACROSS CATEGORIES OF SERVICE

JOINT AND COMMON COST ALLOCATION,
REASONABLE PROFITABILITY,
PRECLUSION OF EVASION THROUGH RETIERING

DETAILS OF RATE REGULATION APPLIED TO THREE SERVICE CATEGORIES (BASIC SERVICES, CABLE PROGRAMMING SERVICES, PER-CHANNEL/PROGRAM)

SPECIFIC RATE STANDARD,
RATES ON SYSTEMS SUBJECT TO COMPETITION,
ADVERTISING AND OTHER REVENUE,
JOINT AND COMMON COST ALLOCATIONS RULES,
DIRECT COSTS,
PROFIT,
RATE COMPARISONS,
OTHER FACTORS

television market, Congress sought to protect consumers from undue market power and promote full competition. The Commission's obligation under the statue are clear. Above all, the Commission must protect cable subscribers from prices which exceed those that would prevail in effectively competitive markets. See § 2 (b) and § 623 (a) and (b).

The Commission cannot leave cable subscribers paying more than competitive market prices. The Commission must, therefore, roll rates back to those levels. Failure to do so would deny subscribers protection from the exercise of undue market power, the most clearly stated goal of the law.

This obligation to protect subscribers is paramount. In crafting regulations, the Commission must consider a number of factors, but those factors cannot dilute the obligation of the Commission to protect subscribers.

2. THE COMPETITIVE MARKET MODEL

The Act shows that Congress would prefer a competitive cable market solution and has instituted a number of policies to stimulate competition. In the absence of competition, however, the Act specifies that regulation is necessary. In order to best achieve its obligation, the Commission should craft a regulatory scheme that approximates the competitive market outcome as closely as possible.

With respect to prices, this outcome is well known. The competitive market ensures that consumers receive all goods and services at cost. That cost would include a reasonable, or normal profit. In the economic literature reasonable profits exclude excess, monopoly or economic profits. Furthermore, in a competitive market, suppliers would be constantly compelled to provide more channels and to upgrade their service as new technology permits, at a cost without excess profits. If they fail to do so -- if they fail to innovate as others do or try to charge prices in excess of costs -- they risk losing market share and ultimately would be put out of business by more efficient suppliers who offer better service at lower prices.

3. SPECIFICATION OF THE GOALS

This view of the Act's overarching goals emanates from the goals section (§ 2 (b)), the regulation section (§ 623), and the Conference Report's description of legislative intent (see § II. A., supra).

First, in the Act's goals section Congress stated:

- a preference for a market solution;

- recognized that cable expansion should occur only where economically justified; and

- mandated consumer protection where competition is lacking to reduce market power.

These goals embody the essence of the competitive market outcome. Economic justification for expansion in the competitive market embodies technological progress, but that progress only comes about where the industry can attract resources in a competitive marketplace to implement the technology.

Provision of service in a competitive market entails relentless pressure to improve service and lower price to prevent loss of business. In a competitive system rates would be set at cost. The ideal regulatory scheme would deliver all cable channels at cost. In a technologically dynamic industry, costs would be falling and quality would be rising. Prices would be falling and service improving.

Second, in the Act's regulation provisions, Congress restated the importance of achieving a competitive market outcome. To meet this objective, Congress laid out the elements of a cost-based regime of regulation which not only identified the categories of cost, but also sources of revenue that should be taken into account, and the allocation principles that the Commission should apply (see § 623 (a)-(c)).

Above all, when the profits of cable companies are considered, they must only be reasonable. Reasonable profits cannot include monopoly profits (or economic profits). (See § 623 (b)(2)(c)(vii).)

Third, the Conference Report reiterates this view of industry regulation with considerable force. It brings the elements of regulation together in a powerful structure to protect subscribers from abuse.

As described in Section II. A., supra, the Conference stressed that joint and common costs would be recovered in rates for all services. In order to protect consumers, it allowed the profitability of individual services and the overall rate of profit to be considered to ensure that only reasonable rates were charged to consumers.

Furthermore, although the Act requires the Commission to reduce the regulatory burden and allows the Commission to use formulas, the Commission cannot prescribe regulation without looking explicitly at the major categories of cost. The Act and Conference Report are clear on this point. See § 623 (b)(2)(A) and (C).[22]

[22] Conference Report at 62-63.

PART 2: INDUSTRY STRUCTURE

III. THE STRUCTURE OF THE CABLE INDUSTRY

A. STRUCTURE, CONDUCT, AND PERFORMANCE DEFINED

In order to describe the economic dynamics of the industry and the pattern of behavior that has developed under deregulation this section and the next adopt the Structure Conduct Performance (SCP) approach to industry analysis. The SCP approach has been the dominant public policy paradigm in the United States for the better part of this century.[23]

The elements of the approach can be described as follows.

> Performance in particular industries or markets is said to depend upon the conduct of sellers and buyers in such matters as pricing policies and practices, overt and taciturn interfirm cooperation, product line and advertising strategies, research and development commitments, investment in production facilities, legal tactics (e. g. enforcing patent rights), and so on. Conduct depends in turn upon the structure of the relevant market, embracing such features as the number

[23] F.M. Sherer, Industrial Market Structure and Economic Performance (New York: Rand McNally, 1990), at 4:

> We seek to identify sets of attributes or variables that influence economic performance and to build theories detailing the nature of the links between these attributes and end performance. The broad descriptive model of these relationships used in most industrial organization studies was conceived by Edward S. Mason at Harvard during the 1930s and extended by numerous scholars.

> and size distribution of buyers and sellers, the degree of physical or subjective differentiation prevailing among competing seller's products, the presence or absence of barriers to entry of new firms, the ratio of fixed to total costs in the short run for a typical firm, the degree to which firms are vertically integrated from raw material production to retail distribution and the amount of diversity or conglomerateness characterizing individual firms's product lines.
>
> Market structure and conduct are also influenced by various <u>basic conditions</u>. For example, on the supply side, basic conditions include the location and ownership of essential raw materials; the characteristics of the available technology (e.g. batch versus continuous process productions or high versus low elasticity of input substitution); the degree of work force unionization; the durability of the product; the time pattern of production (e.g. whether goods are produced to order or delivered from inventory); the value/weight characteristics of the product an so on. A list of significant basic conditions on the demand side must include at least the price elasticity of demand at various prices; the availability of (and cross elasticity of demand for) substitute products; the rate of growth and variability over time of demand; the method employed by buyers in purchasing (e.g. acceptance of list prices as given versus solicitation of sealed bids versus haggling); and the marketing characteristics of the product sold (e.g. specialty versus convenience shopping method).[24]

This section discusses market structural characteristics, which are qualitative in nature and generally lay the groundwork for the evaluation of industry performance. The next section reviews the quantitative evidence on the basic performance of the industry before and after deregulation.

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[24] Ibid., at 4-5.

B. BASIC CONDITIONS

For the cable industry, we see the basic supply and demand side conditions as follows.

1. THE DEMAND-SIDE

On the demand side, a low to moderate price elasticity and a positive income elasticity are crucial. They convey market power and an ideal opportunity for the cable industry to expand.

Econometric analyses of demand elasticities for the cable industry yield estimates that are quite low.[25] Prior to deregulation they were at or below 1. Since deregulation estimates have been somewhat higher, although credible estimates are still in the range of 1 to 2. The abusive pricing of cable

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[25] Mayo, J. W. and Y. Otsuka, "Demand, Pricing and Regulation, Evidence from the Cable TV Industry," Rand Journal of Economics, Autumn, 1991; Pacey, P. L., "cable Television in a Less Regulated Market," Journal of Industrial Economics, September, 1985; Webb, G.K., The Economics of Cable Television (Lexington: Lexington Books, 1983); Duncan, K. R. and C.F. DeKay, Estimation of an Urban Cable Demand Model and Its Implications for Regulation for Major Markets, Center for Metropolitan Planning and Research, Johns Hopkins University, March 1976; Charles River Associates, Analysis of the Demand for Cable Television, April 1973; Noll R.G., M.J. Peck, and M.J. McGowan, Economic Aspects of Television Regulation (Washington, D.C.: The Brookings Institution); R.E. Park, "Prospects for Cable in the 100 Largest Television Markets," Bell Journal of Economics and Management Science, Spring, 1972; Commanor, W.S. and B. M. Mitchell, "Cable Television and the Impact of Regulation," Bell Journal of Economics and Management Science, Spring, 1971, all find demand elasticities less than 1.5, even in large urban markets.

services since deregulation may have driven demand into its more elastic range. Even if the elasticity is in the range of one-to-two, the market is extremely problematic from the point of view of the exercise of market power.[26]

Webb summarized the findings on price elasticity as follows.

> The lack of apparent close substitutes for basic cable suggests that demand should be relatively insensitive to changes in price. Households are inclined to endure a price increase when there are few substitutes available in the form of alternative services.... the price elasticity of demand for basic cable was measured to be between -1 and 0 over the normal range of prices. The negative value confirms, as expected, that market penetration and price are inversely related... An absolute value of less than 1 indicates, also as expected, that the demand for basic cable is relatively insensitive to changes in price; in economic terms, demand is inelastic...
>
> Demand for basic cable becomes more elastic -- more price sensitive -- as prices rise...[27]

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[26] As Landis and Posner put it (W. M. Landes and R. A. Posner, "Market Power in Anti-trust Cases," Harvard Law Review, 94: 1981, p. 50.)

> The higher the elasticity of demand for the firm's product at the firm's profit maximizing price, the closer that price will be to the competitive price, and the less, therefore, the monopoly overcharge will be... an infinite elasticity of demand means that the slightest increase in price will cause quantity demanded to fall to zero. In the opposite direction, the formula "comes apart" when the elasticity of demand is 1 or less. The intuitive reason is that a profit maximizing firm would not sell in the inelastic region of its demand curve because it could increase its revenue by raising price and reducing quantity.

[27] Webb, op. cit., at 81.

The same is true of the income elasticity. At the most macro level, income growth and increasing penetration are correlated. At the most micro level, higher income households are much more likely to subscribe. Lower income households are much less likely to subscribe (See Figure III-1). Virtually every econometric study of the cable industry which includes this variable finds a moderately, positive income elasticity, generally in the range of .5 to 1.[28]

Low to moderate price elasticity and low to moderate income elasticity both feed off fundamental television viewing patterns that have been established over four decades. Americans watch a significant amount of television -- in the neighborhood of eight hours per day.[29] Television has come to be the premier source of information and entertainment in American life. Deeply entrenched viewing patterns and strong demand for entertainment, news, information, and sports make the market potential for cable huge. The ability to deliver large numbers of channels gives cable a huge advantage in meeting this demand.

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[28] Over time, however, the income elasticity declines as cost relative to income declines and the commodity comes to be seen more and more as a necessity. Studies finding positive income elasticities include Pacey, op. cit.; Parks, op. cit.; Mayo and Otsuka, op. cit.; Lyall, et al., op. cit; Charles River Associates, op. cit.; Noll and Peck, op. cit.; Commanor and Mitchell, op. cit.

[29] Consumer Reports in Competitive Issues in the Cable Television Industry, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress, March 17, 1988, at 244.